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No. 752

IN THE

# Supreme Court of the United States

**October Term, A. D., 1940.**

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SOUTHWESTERN HOTEL COMPANY,
*Petitioner,*

versus

UNITED STATES OF AMERICA,
*Respondent.*

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## PETITION AND BRIEF FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF THE UNITED STATES.

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## PETITION AND BRIEF FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF THE UNITED STATES.

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*To The Supreme Court of the United States:*

Your Petitioner, Southwestern Hotel Company, respectfully requests this Court to review by Writ of Certiorari a judgment of the United States Circuit Court of Appeals for the Fifth Circuit, in which that Court affirmed a decree of the District Court for the El Paso Division of the Western District of Texas.

In the trial court, Southwestern Hotel Company sought to recover from the United States $989.24, with interest from March 10, 1939, at 6% per annum. It alleged that the ninety-nine year lease under which it occupied the Hilton Hotel in El Paso, Texas, required it, as the Lessee, to pay, *as a part of the rent,* the sum of $18,000.00 accruing in the fiscal year ending August 31,

1935, on the principal of a mortgage on the Hilton Hotel, and that it had deducted this $18,000.00 *paid as rent* from its gross income for that fiscal year. It alleged that it had been required by the Collector of Internal Revenue to pay an additional income and excess profits tax of $989.24, on the idea that the proper deduction should have been $12,720.00 instead of 18,000.00, based on the theory that the principal of the mortgage, $424,000.00, should have been prorated over the presumed life of the Hilton Hotel building, 33-1/3 years. It alleged that a proper claim for refund had been filed, upon which no action had been taken for more than six months. It sought to recover the illegal tax from the United States.

The Trial Court held that the contention of the Commissioner of Internal Revenue was correct, and denied a recovery. On appeal to the United States Circuit Court of Appeals for the Fifth Circuit, that Judgment was affirmed, on the theory that while the principal of the $424,000.00 mortgage should not have been prorated over the 33-1/3 year life of the building, it should have been prorated over the ninety-nine year term of the lease, and since that would have resulted in a larger tax than the tax actually paid, Southwestern Hotel Company could not complain, and the judgment of the Trial Court should therefore be affirmed.

## A. SUMMARY STATEMENT OF THE MATTERS INVOLVED.

1. The lease between Albert Mathias and wife, as Lessors, and Southwestern Hotel Company, as Lessee, provides in Article II for cash monthly rentals, in fixed amounts, during the period from September 1, 1933, to August 31, 1950. It provides that after August 31, 1950, there shall be substituted for these fixed monthly rentals

a monthly rental which would yield a net annual return of 6% on the then ground value of the Mathias property. The lease also provides that as "Additional Money Rentals" the Lessee should pay the sums due and to become due on the Pacific Mutual Life Insurance Company mortgage, upon which there remained, after September 1, 1933, a balance of $424,000.00, maturing in fixed amounts each year for a period of years. It is further provided in the lease that the Lessee shall be required to reduce the principal amount of the mortgage not less than $12,000.00 a year during the first three years of the lease and not less than $20,000.00 a year during the succeeding years of the lease. It also provides that the Lessor should be required to join with the Lessee in refinancing agreement so as to extend and renew the indebtedness secured by the mortgage from time to time to permit payments on the principal of not less than $20,000.00 a year after the first three years. Section 2 of Article III of the lease provides a way for assistance to the Lessee to prevent it from being required to pay more than $12,000.00 a year during the first three years of the lease. Can the Lessee, under such a lease, deduct for the fiscal year ending August 31, 1935, as a part of its rental expense, the sum of $18,000.00, the actual amount payable during that year on the principal of the mortgage, or can he only deduct $4283.00, an amount equal to $424,000.00 divided by ninety-nine, the number of years that the lease had to run, as held by the United States Circuit Court of Appeals?

2. Under the lease such as is referred to in the preceding question, can the Lessee deduct for the fiscal year ending August 31, 1935, as a part of his rental expense, the sum of $18,000.00, the actual amount payable during that year, or can he only deduct $12,720.00, an amount

equal to $424,000.00 divided by thirty-three and one-third, the number of years which the building on the leased premises will be presumed to last, as held by the Trial Court?

We shall state sufficient of the pleadings and of the evidence to show that the above questions are involved in the decision of this case.

## Pleadings.

*Plaintiff's Original Petition, filed October 25, 1939, (R. 2 to 14).*

1. In due time, Plaintiff filed its income tax return for its fiscal year September 1, 1934, to August 31, 1935, showing a deduction of $27,500.00 on account of payments made during such fiscal year to The Pacific Mutual Life Insurance Company of California on the principal of its mortgage on the Hilton Hotel property, and paid the income tax so arrived at. The deduction was taken because the payment was due as a part of the rents payable under Plaintiff's lease on the Hilton Hotel property. The Internal Revenue Agent objected to the deduction of $27,500.00 on the ground that only $18,000.00 actually accrued and became due on the mortgage during the period in question, the Lessee having paid $9500.00 more than it was actually required to pay during such fiscal year. Plaintiff acquiesced in the ruling, and paid the additional tax requested (R. 2).

2. Thereafter, the Commissioner of Internal Revenue ruled that while $18,000.00 became due and payable under the lease and mortgage for the fiscal year, said payment should not be considered as deductible for that year. The ruling was to the effect that the principal

amount of the mortgage should be spread over the life of the Hilton Hotel Building, which was fixed at 33-1/3 years. So allocated, the annual allowable deduction was fixed at $12,720.00, and the net income for the year was increased by the difference between $18,000.00 and $12,-720.00, or $5280.00. This resulted in a deficiency assessment of $989.24 (R. 2, 3).

3. The Collector demanded payment of $989.24, with interest to March 10, 1939, at 6% per annum, making a total of $1185.27. Payment was made in accordance with this demand, and said sum has heretofore been retained by the United States (R. 3, 4).

4. On March 28, 1939, Plaintiff duly filed a claim for refund, claiming that the full $18,000.00 was a deductible expense for the fiscal year 1934-1935. The claim was received by the Collector on March 31, 1939. For more than six months after the receipt of the claim, the United States, its Commissioner of Internal Revenue, and its Collector of Internal Revenue, at Austin, Texas, failed to act on said claim (R. 3-7).

5. Payment of $18,000.00 was made by Plaintiff in accordance with the terms of a lease for a period of ninety-nine years, beginning September 1, 1933, and ending the 31st of August, 2032, containing provisions customarily found in a long term lease of that character, including certain provisions with reference to the payment of cash monthly rentals and the payment of taxes and insurance, and a further provision requiring the Lessee to pay as "Additional Money Rentals" the amounts accruing annually on the principal of a note secured by mortgage against the Hilton Hotel property, held by The Pacific Mutual Life Insurance Company of California, it being provided that the Lessee should, during the first three years of the lease, pay at least $12,000.00 a year

upon the principal and should thereafter pay at least $20,000.00 a year on the principal of said indebtedness. By the express terms of the lease, the payments to The Pacific Mutual Life Insurance Company of California were made a part of the money rentals to be paid by the Lessee, and in the event of a termination of the lease the liability of the Lessee to continue to make payments on said mortgage would have terminated in the same manner as the liability of the Lessee for the payment of monthly rentals (R. 8-16).

6. The unpaid balance on the note held by The Pacific Mutual Life Insurance Company of California on September 1, 1933, was $425,000.00, of which $1000.00 was paid on September 1, 1933. The $424,000.00 balance on said note was, by the agreement of the parties interested in said obligation, payable over a period of years, and by said agreements there became due and payable on said indebtedness during the fiscal year which ended August 31, 1935, the sum of $18,000.00, and by virtue of Article III of the above mentioned lease the Lessee in said lease was compelled to pay as additional monthly rentals for said fiscal year the total sum of $18,000.00, and said sum actually accrued for said fiscal year as a part of the rents payable under said lease, and said sum was actually paid during said twelve months' period. The payment of the $18,000.00 was properly chargeable as rents and expenses of the Plaintiff for said fiscal year, and should have been so allowed in the calculation of the income tax and excess profits tax payable by the Plaintiff to the United States for said fiscal year (R. 16-17).

7. All income taxes, excess profits taxes and all other sums of every kind due and payable by the Plaintiff to the United States upon all accounts have been

paid, and there are no sums now due and payable from this Plaintiff to the United States, and Plaintiff is entitled to recover from the United States the sum of $989.-24, with 6% interest per annum from the 15th of November, 1935 (R. 17).

Plaintiff prayed for the recovery of $989.24, interest and costs (R. 17).

*Defendant's First Amended Original Answer, filed February 19, 1940 (R. 19-21).*

The United States, in its Amended Answer, admitted substantially all of the allegations of fact contained in Plaintiff's Original Petition, but alleged that the $18,-000.00 referred to in Plaintiff's Petition was paid by the Plaintiff on the mortgage described in Plaintiff's Petition as a part of the consideration for the use of the property for years other than the taxable year, and that only the part thereof properly attributable to the process of earning income during the taxable year in question was deductible from Complainant's gross income for such year; that the amount so attributable was $12,720.00, and that this was the only amount that could be deducted as an expense during said taxable year, and that the sum of $5280.00 out of said $18,000.00 payment was properly disallowed as an expense for said year.

## Evidence.

*Testimony of E. H. Krohn (R. 42-54).*

This is the original lease which was made by Albert Mathias as lessor and Hilton Hotels, Inc., as lessee, on October 9, 1929. It was dated as of September 1, 1929, and was signed October 9, 1929 (R. 42-43). (*This is not the lease directly involved here.*)

This is a supplement to that original lease. This instrument slightly modified the description of the property, and recited that the lessor and the lessee were executing a deed of trust on the real estate covered by the lease to secure a note signed by the lessee, for the purpose of providing funds with which to partially pay for the cost of erecting improvements upon the real estate, and the lessee covenanted and agreed to pay the payments accruing on said note, and that in the event it should default in making such payments the lessor might terminate the lease. The instrument provided for certain liens in favor of the lessor to secure performance by the lessee, and was dated February 21, 1930 (R. 43).

This is a certified copy of the deed of trust of The Pacific Mutual Life Insurance Company of California. This Deed of Trust was executed by Albert Mathias and Frieda Mathias, covering the Hilton Hotel property, which was conveyed to two trustees to be held in accordance with the terms of the deed of trust. It recited that it was given to secure the payment of a note dated February 28, 1930, in the principal amount of $450,000.00, bearing interest from date at the rate of 6% per annum, payable May 1, 1930, and quarterly thereafter. The principal amount of the note was payable as follows:

$2500.00 on August 1st and November 1, 1931, and on February 1st and May 1, 1932;
$4500.00 on August 1st and November 1, 1932, and on February 1st and May 1, 1933;
$5000.00 on August 1st and November 1, 1933, and on February 1st and May 1, 1934;
$5000.00 on August 1st and November 1, 1934, and on February 1st and May 1, 1935;
$5500.00 on August 1st and November 1, 1935, and on February 1st and May 1, 1936;
$6000.00 on August 1st and November 1, 1936, and on February 1st and May 1, 1937;

$6000.00 on August 1st and November 1, 1937, and on February 1st and May 1, 1938;
$6500.00 on August 1st and November 1, 1938, and on February 1st and May 1, 1939;
$7000.00 on August 1st and November 1, 1939, and on February 1, 1940; and
$265,000.00 on May 1, 1940.

The deed of trust had the usual provisions with reference to acceleration of maturity in event of default, and with reference to sale of the property by the trustees. The other provisions are not material here (R. 43-44).

The Hilton Hotel property, since 1934, has been and is now owned as follows: one-fifth (1/5) by Albert Mathias and wife, and four-fifths (4/5) by Mathias Trust Estate (R. 44-45).

A printed copy of *the present lease* was introduced. This lease was executed by Albert Mathias and Frieda Mathias as Lessors and Southwestern Hotel Company as Lessee, as of September 1, 1933, and ran for a period of ninety-nine years, beginning September 1, 1933, and ending August 31, 2032. The lease covered the Hilton Hotel property. The lease contained the provisions as described in Paragraph VIII in Plaintiff's Petition in this suit (R. 45). (*This is the lease directly involved here.*)

**Court's Findings of Fact and Conclusions of Law and Judgment** (R. 22-28 and R. 37-38).

The Trial Judge found the facts to have been substantially as pleaded by Plaintiff. He concluded that the law was with the Defendant, holding that Plaintiff could not deduct the $18,000.00 which it was required to pay as rent during the fiscal year on the principal amount of the mortgage of The Pacific Mutual Life Insurance Company, but that it could only deduct 1/33-1/3 part of

the $424,000.00 principal amount of the mortgage. In other words, the Court held that the $424,000.00 principal amount of the mortgage should be divided by 33-1/3, the number of years which the present Hilton Hotel building would be presumed to exist, and the resulting figure, $12,720.00, was the amount deductible during each of the 33-1/3 years, beginning with the inception of the lease.

Plaintiff was denied any recovery.

## B. REASON RELIED UPON FOR THE ALLOWANCE OF THE WRIT.

The lease between Albert Mathias and wife as Lessors and Southwestern Hotel Company as Lessee, provides in Article II for cash monthly rentals in fixed amounts during the period from September 1, 1933, to August 31, 1950. It provides that after August 31, 1950, there should be substituted for these fixed monthly rentals a monthly rental which would yield a net annual return of 6% on the then ground value of the Mathias property. The lease also provided that as "Additional Money Rentals" the Lessee should pay the sums due and to become due on the Pacific Mutual Life Insurance Company mortgage, upon which there remained, after September 1, 1933, a balance of $424,000.00, maturing in fixed amounts each year for a period of years. It is further provided in the lease that the Lessee shall be required to reduce the principal amount of the mortgage not less than $12,000.00 a year during the first three years of the lease and not less than $20,000.00 a year during the succeeding years of the lease. It also provides that the Lessor should be required to join with the Lessee in refinancing agreements so as to extend and renew the indebtedness secured by the mortgage from time to time to

permit payments on the principal of not less than $20,000.00 a year, after the first three years. Section 2 of Article III of the lease provides a way for assistance to the Lessee to prevent it from being required to pay more than $12,000.00 a year during the first three years of the lease. The Circuit Court of Appeals held that the Lessee could not deduct for the fiscal year ending August 31, 1935, as a part of its rental expense the sum of $18,000.00, the actual amount payable during that year as rent, but could only deduct $4283.00, an amount equal to $424,000.00 divided by ninety-nine, the number of years that the lease had to run, and that therefore the Judgment of the lower court in permitting a deduction of $12,720.00, an amount equal to $424,000.00 divided by 33-1/3, the number of years which the building on the leased premises would be presumed to last, should be affirmed.

THE CIRCUIT COURT OF APPEALS, IN MAKING SAID DECISION, HAS ERRONEOUSLY DECIDED AN IMPORTANT QUESTION OF FEDERAL LAW, WHICH HAS NOT BEEN, BUT WHICH SHOULD BE, SETTLED BY THE SUPREME COURT.

## PRAYER FOR WRIT.

Wherefore, your Petitioner prays that the writ of certiorari be issued out of and under the seal of this Court, directed to the Circuit Court of Appeals for the Fifth Circuit, commanding that Court to certify and send to the Supreme Court a full and complete transcript of the record, and of all the proceedings in the case numbered and entitled on its docket, "No. 9556, Southwestern Hotel Company, Appellant, versus United States of America, Appellee", to the end that this case may be reviewed and determined by this Honorable Court, as pro-

vided by the statutes of the United States, and that the Judgment of the Circuit Court of Appeals for the Fifth Circuit be reviewed and reversed, and for such other relief as may seem proper to this Court.

DATED at El Paso, Texas, this 31st day of January, 1941.

Respectfully submitted,

SOUTHWESTERN HOTEL COMPANY,
*Petitioner,*

By:

THORNTON HARDIE,
Of El Paso, Texas,

*Attorney for Petitioner.*

# BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

## I.

## OPINION IN THE COURT BELOW.

The opinion of the United States Circuit Court of Appeals for the Fifth Circuit is reported on page ....., Volume ....., Federal Reporter, Second Series. It is found on pages 59 to 63 of the Record. The opinion was written by Judge Holmes and concurred in by Judges Hutcheson and Foster.

## II.

## STATEMENT OF JURISDICTION.

(a) This is a suit by Southwestern Hotel Company against the United States to recover $989.24, together with interest at 6% from March 10, 1939. Jurisdiction is based upon Section 41, Tit. 28, U. S. C. A. (R. S. of U. S., Sections 563, 629), which read in part as follows:

> "The District Courts shall have original jurisdiction as follows:
>
> "(1) . . . where the matter in controversy exceeds, exclusive of interest and costs, the sum or value of $3000.00, and (a) arises under the Constitution or laws of the United States, . . . The foregoing provision as to the sum or value of the matter in controversy shall not be construed to apply to any of the cases mentioned in the succeeding paragraphs of this section . . .
>
> "(5) *Cases under internal revenue, customs, and tonnage* laws. Fifth. Of all cases arising under any law providing for internal revenue, . . . "

(b) The statutory provision which is believed to sustain the jurisdiction of this Honorable Court is Section 347, of Tit. 28, U. S. C. A. (Judicial Code, Section 240, amended). The application is filed under Section 5, Rule 38 (former rule 35) of the Rules of the Supreme Court.

(c) The Judgment of the Trial Court is dated March 23, 1940 (R. 37). The Judgment of the Circuit Court of Appeals is dated November 19, 1940 (R. 63).

(d) This case involves the determination of important questions of Federal law which have not been but should be settled by the Supreme Court.

(1) The lease between Albert Mathias and wife, as Lessors, and Southwestern Hotel Company, as Lessee, provides in Article II for cash monthly rentals, in fixed amounts, during the period from September 1, 1933, to August 31, 1950. It provides that after August 31, 1950, there shall be substituted for these fixed monthly rentals a monthly rental which would yield a net annual return of 6% on the then ground value of the Mathias property. The lease also provides that as "Additional Money Rentals" the Lessee should pay the sums due and to become due on the Pacific Mutual Life Insurance Company mortgage, upon which there remained, after September 1, 1933, a balance of $424,000.00, maturing in fixed amounts each year for a period of years. It is further provided in the lease that the Lessee shall be required to reduce the principal amount of the mortgage not less than $12,000.00 a year during the first three years of the lease, and not less than $20,000.00 a year during the succeeding years of the lease. It also provides that the Lessor should be required to join with the Lessee in refinancing agreement so as to extend and renew the indebtedness

secured by the mortgage from time to time to permit payments on the principal of not less than $20,000.00 a year after the first three years. Section 2 of Article III of the lease provides a way for assistance to the Lessee to prevent it from being required to pay more than $12,000.00 a year during the first three years of the lease. Can the Lessee, under such a lease, deduct for the fiscal year ending August 31, 1935, as a part of its rental expense, the sum of $18,000.00, the actual amount payable during that year, or can he only deduct $4283.00, an amount equal to $424,000.00 divided by ninety-nine, the number of years that the lease had to run, as held by the United States Circuit Court of Appeals?

(2) Under the lease such as is referred to in the preceding question, can the Lessee deduct for the fiscal year ending August 31, 1935, as a part of his rental expense, the sum of $18,000.00, the actual amount payable during that year, or can he only deduct $12,720.00, an amount equal to $424,000.00 divided by thirty-three and one-third, the number of years which the building on the leased premises will be presumed to last, as held by the Trial Court?

## III

## STATEMENT OF THE CASE.

The statement of the case in the preceding petition, pages 4 to 10, is hereby made a part of this brief.

The proceedings in the Circuit Court of Appeals were sufficient to raise the questions here presented. The opinion of the Circuit Court of Appeals is found on pages 59 to 63 of the Record.

## IV.

## SPECIFICATION OF ERRORS.

In affirming the judgment of the Trial Court, the Circuit Court of Appeals erred in the following particular:

The lease between Albert Mathias and wife, as Lessors, and Southwestern Hotel Company, as Lessee, provides in Article II for cash monthly rentals in fixed amounts during the period from September 1, 1933, to August 31, 1950. It provides that after August 31, 1950, there should be substituted for these fixed monthly rentals a monthly rental which would yield a net annual return of 6% on the then ground value of the Mathias property. The lease also provided that as "Additional Money Rentals" the Lessee should pay the sums due and to become due on the Pacific Mutual Life Insurance Company mortgage, upon which there remained, after September 1, 1933, a balance of $424,000.00, maturing in fixed amounts each year for a period of years. It is further provided in the lease that the Lessee shall be required to reduce the principal amount of the mortgage not less than $12,000.00 a year during the first three years of the lease and not less than $20,000.00 a year during the succeeding years of the lease. It also provides that the Lessor should be required to join with the Lessee in refinancing agreements so as to extend and renew the indebtedness secured by the mortgage from time to time to permit payments on the principal of not less than $20,000.00 a year, after the first three years. Section 2 of Article III of the lease provides a way for assistance to the Lessee to prevent it from being required to pay more than $12,000.00 a year during the first three years of the lease. The Circuit Court of Appeals held that the Lessee could not de-

duct for the fiscal year ending August 31, 1935, as a part of its rental expense the sum of $18,000.00, the actual amount payable during that year as rent, but could only deduct $4283.00, an amount equal to $424,000.00 divided by ninety-nine, the number of years that the lease had to run, and that therefore the Judgment of the lower court in permitting a deduction of $12,720.00, an amount equal to $424,000.00 divided by 33-1/3, the number of years which the building on the leased premises would be presumed to last, should be affirmed.

The Circuit Court of Appeals, in making said decision, has erroneously decided an important question of Federal law, which has not been, but which should be, settled by the Supreme Court.

## V.

## SUMMARY OF ARGUMENT

We shall present our views under one point.

In this case, the lease provided in one article for monthly cash rentals in fixed amounts during the period from September 1, 1933, to August 31, 1950. It provided that after August 31, 1950, there should be substituted for these fixed monthly rentals a monthly rental which would yield a net annual return of 6% on the then ground value of the Mathias property. The lease also provided that as "Additional Money Rentals" the Lessee should pay certain amounts maturing each year on the principal of a mortgage secured by a lien upon the leased property, and that the mortgage might be so handled by the Lessee as to permit payments of not less than $12,000.00 a year during the first three years and $20,000.00 a year during succeeding years of the lease. It

is our contention that the annual amounts paid by the Lessee on the principal of the mortgage as a part of the rentals should be considered as an annual rental expense, and should be deducted as such in arriving at the net income of the Lessee. We think our contention is fully supported by Section 23(a) of the Revenue Act of 1934, 26 U. S. C. A., which reads:

> "Section 23. Deductions from Gross Income.
>
> "In computing net income, there shall be allowed as deductions:
>
> "(a) Expenses . . . and rentals or other payments required to be made as a condition to the continued use or possession for purposes of the trade or business of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

These payments are expressly designated in the lease as "Additional Money Rentals", and if the lease were cancelled the obligation to continue to make the payments on the mortgage would terminate in the same manner as the obligation to make any other unmatured rental payments. Moreover, if the tenant failed to make these payments on the mortgage as they matured, the right to occupy the premises would be subject to termination. Clearly, these were "payments required to be made as a condition to the continued use or possession . . . of property . . . ". If the lease terminated the obligation to continue to make the payments ceased. If the payments were not made, the right to continued occupancy of the premises ceased.

The opinion in *Midtown Tower, Inc. v. Commissioner of Internal Revenue,* 40 B. T. A. 116, fully set out as Appendix One to this brief, is directly in point, and fully

sustains all of our contentions. The Commissioner of Internal Revenue made the same contentions in that case that we are making here. Great deference should be shown to the expressed judgment of the Commissioner of Internal Revenue and of the Board of Tex Appeals in matters of this character. We do not believe it would be possible to find another case so similar in all respects to ours. In that case as in ours, the original lease was made with another lessee, who signed the mortgage upon which the payments were to be later made. The original Lessee dropped out of the picture, and the new Lessee was the taxpayer before the Board of Tax Appeals. *In that case, as in ours, the new Lessee did not assume or become personally liable upon the mortgage. His only obligation to pay the principal installments becoming due on the mortgage was the obligation made as the Lessee in the lease, and he agreed to pay such principal sums as a part of the rent.*

## VI.

## ARGUMENT.

### Point.

Under a lease such as is shown to have existed in this case, by which the Lessee was required to pay as "Additional Money Rentals" the principal amounts accruing each year on the note held by the Pacific Mutual Life Insurance Company the amount paid by the Lessee on the principal amount of the mortgage should be considered as annual rental expense in calculating the annual net income of the Lessee for tax purposes.

## Argument.

The lease between Albert Mathias and wife, as Lessors, and Southwestern Hotel Company, as Lessee, provides in Article II for cash monthly rentals in fixed amounts during the period from September 1, 1933, to August 31, 1950. It provides that after August 31, 1950, there should be substituted for these fixed monthly rentals a monthly rental which would yield a net annual return of 6% on the then ground value of Mathias' property. The lease also provided that as "Additional Money Rentals", the Lessee should pay the sums due and to become due on the Pacific Mutual Life Insurance Company mortgage, upon which there remained after September 1, 1933, a balance of $424,000.00, maturing in fixed amounts each year for a period of years. It is further provided in the lease that the Lessee shall be required to reduce the principal amount of the mortgage not less than $12,000.00 a year during the first three years of the lease, and not less than $20,000.00 a year during the succeeding years of the lease. It also provides that the Lessor should be required to join with the Lessee in refinancing agreements so as to extend and renew the indebtedness secured by the mortgage from time to time, to permit payments on the principal of not less than $20,000.00 a year after the first three years. Section (2) of Article III of the lease provides a way for assistance to the Lessee to prevent it from being required to pay more than $12,000.00 a year during the first three years of the lease.

A reading of the terms of the lease makes it quite evident that the parties intended that the Lessee should pay approximately, and in any event not less than, $12,000.00 a year on the principal during the first three years

and $20,000.00 a year during the period required to completely retire the mortgage. The lease, as drawn, is susceptible to the construction that Lessor and Lessee both realized that during the first seventeen years of the lease, while the building was camparatively new, the rents should be higher than during the balance of the lease, unless the ground value of the property should increase, and that during these high income years the rent should be sufficient to pay out practically the entire principal amount of the Lessor's mortgage indebtedness. In other words, it was contemplated that during the first seventeens years of the lease, with a modern, recently constructed building, the Lessee should be able to pay the fixed monthly rents described in Paragraph II, and also be able to either pay the Pacific Mutual Life Insurance Company mortgage in full, or to reduce it to a comparatively small sum. It was contemplated that after seventeen years, when the building would be twenty years old and obsolete, the rent should be based solely on the ground value of the property. It seems to us reasonable for the parties to have thought it proper to have a larger annual rental expense during the profitable years of the building than during the more unprofitable years. It seems unreasonable for the Government to insist that the Lessee should, in the payment of income taxes, pay upon an arbitrary annual expense instead upon the actual annual expense.

Let us suppose that the lease had provided for cash monthly rentals, as set up in Article II of the lease, and then, instead of providing for payments on the Pacific Mutual Life Insurance Company mortgage, had provided that as additional monthly rentals the Lessee should pay $20,000.00 a year for the first twenty-one years of the lease, and that during the last seventy-eight years of the

lease the total annual money rents should be 6% of the ground value of the property. We do not think that any one would then claim that during the first twenty-one years the Lessee should not deduct, as a part of his annual rental expense, the full $20,000.00.

Suppose, for instance, that the lease, in recognition of the probable decreasing rental value of the property, had provided that during the first thirty-three years the total annual money rental should be $24,000.00; that during the second thirty-three years it should be $20,000.00, and during the last thirty-three years it should be $15,000.00. Would anyone contend that the Lessee should not be allowed to deduct each year the actual amount of rent paid during that year? The mere fact that there is a variation in the amount of rent payable during the different periods of the lease does not call for a proration of rent over the entire lease for income tax purposes. For instance, the lease actually provides in Article II for the following schedule of monthly rental payments:

September 1, 1933, to August 31, 1935—$1250.00 a month;

September 1, 1935, to August 31, 1940—$1500.00 a month;

September 1, 1940, to August 31, 1945—$1750.00 a month;

September 1, 1945, to August 31, 1948—$2000.00 a month;

September 1, 1948, to August 31, 1950—$2500.00 a month.

Yet no one has or would suggest that these rents for the first seventeen years should be added together and then

divided by seventeen to determine the average annual rent under this section of the lease, and that the taxpayer should be allowed to deduct this average annual money rent, instead of the actual money rent due, for the particular year in question.

Let us assume that the lease had provided for the varying cash rentals set out in Article II of the lease, and had then provided that during the first twenty-three years of the lease the Lessee should pay as additional annual rents 10% of the gross annual income from the hotel, with the proviso that this additional rent should be at least $12,000.00 during each of the first three years and at least $20,000.00 a year during the succeeding twenty years. It is quite probable that the total annual rental would vary greatly each year, because of the varying amounts of the gross annual income. We do not think that any one would contend that for income tax purposes these extra annual payments, based on 10% of the gross income during the first twenty-three years, should be amortized over the life of the building, or should be amortized over the whole ninety-nine year term of the lease. Certainly it is permissible to provide for varying amounts of annual rentals to be determined by factors not entirely within the control of the Lessor and Lessee without being compelled to prorate this rental expense over the life of the lease. After all, the amount payable each year is the rental expense for that and no other year.

If, merely because under the lease the Lessee pays varying amounts of rent during different periods of the lease, the Lessee is required to prorate the total rent over the life of the lease, or over the particular period in question, then it seems to us that in order to be consistent the Government should take the total of the rents to be

paid during the entire period in question and divide this sum by the number of years in question, and then take this amount as the average annual rent to be deducted each year.

The Government says that the $424,000.00 to be paid by the Lessee as rents under Article III of the lease should be paid over a period of 33-1/3 years. The Circuit Court of Appeals says it should be prorated over a period of ninety-nine years. We say, in order to be consistent, we should take the total rents payable under Articles II, III and IV, which last Article provides for payment of taxes by Lessee, and divide that total by 33-1/3, or by 99, to obtain the real average annual rental for the period in question.

This, of course, would not be a practical suggestion, since it would be difficult to prophesy what the taxes would be during said period of 33-1/3 years or 99 years, and it would be difficult to prophesy what the rent under Article II would be after September 1, 1950, when it will be fixed to yield 6% per annum on the then ground value of the property. It seems to us that the only practical solution is to permit deduction of the actual total amount which becomes payable under the lease as rent during the particular year in question.

If, as a matter of fact, the annual payments are paid as rents or expense for the continuing use of the premises, the actual amount which thus becomes payable during the tax year is deductible under the very terms of the statute itself. Section 23(a) of the Revenue Act of 1934, 26 U. S. C. A., reads:

> "Section 23. Deductions from Gross Income.
>
> "In computing net income, there shall be allowed as deductions:

> "(a) Expenses . . . and rentals or other payments required to be made as a condition to the continued use or possession for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title, or in which he has no equity."

There is no rule which says that merely because the rental varies in amount from year to year the amount to be deducted each year shall be the average annual rent for the period in question.

The Commissioner of Internal Revenue relied upon that portion of Treasury Regulations 86 under Revenue Act of 1934, which reads:

> "Article 23(a)—10. Rentals . . . The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment, and not deductible as a business expense."

and also upon the provisions of Article 22(a)—13 of Treasury Regulations 86 under the Revenue Act of 1934 with reference to "Improvements by Lessee". It is upon this basis that he prorated the $424,000.00 over the life of the building, which is assumed to be 33-1/3 years.

A complete answer is that the Lessee erected no improvements. No justification exists for any application of the above quoted Treasury Regulations to the facts and issues of this case, for the simple reason that the Lessee built no improvements, nor did it agree to pay for any improvements. It merely agreed to pay additional money rentals in amounts required to retire a mortgage upon which the principal would be payable in amounts of at least $12,000.00 a year during the first three years and in amounts of at least $20,000.00 a year thereafter.

Our lease as drawn expressly provides that the payments of the Pacific Mutual Life Insurance Company mortgage are to be considered by the parties as "Additional Money Rentals". The use of these words has a clear legal significance. These words mean that the parties understood and intended, and therefore agreed, that the payments which were to be made from time to time on the mortgage of the Pacific Mutual Life Insurance Company should be considered as rental payments. This meant that if at any time the Lessor should, for any default of the Lessee, terminate the lease, the Lessee would thereafter be relieved from paying installments on the mortgage which had not become due up to the date of the cancellation of the lease. In other words, under the lease as drawn, a termination of the lease would relieve the Lessee from its obligation to continue to make payments on the mortgage of installments which had not become due up to the date of the cancellation of the lease. In other words, under the lease as drawn, a termination of the lease would relieve the Lessee from its obligation to continue to make payments on the mortgage of installments which had not actually become due at the time of the termination, just as such cancellation would relieve the Lessee from making payment of any other unmatured rental payments.

To make this clear, we call attention to the fact that the lease provides that the Lessee shall pay insurance premiums during the entire term of the lease; that it shall pay the taxes accruing on the property during the ninety-nine year term of the lease, and that it shall keep up the repairs on the property during the term of the lease. If at any time the lease were cancelled, the Lessee would, of course, be relieved from keeping any of these covenants for any portion of the term of the lease

subsequent to the date of cancellation. Since the parties expressly agreed that the covenant to pay the principal installments on the Pacific Mutual Life Insurance Company mortgage should be considered as covenants to pay "Additional Money Rentals", a termination of the lease would also relieve the Lessee from paying unmatured installments on the mortgage.

A bonus paid for the making of a lease is a sum which is absolutely payable as a consideration for the execution of the lease. It is not a sum which is to be paid conditioned on the continued life of the lease. If the parties had intended that the obligation to pay the mortgage should be considered as a bonus for the making of the lease, and not as recurring rentals under the lease, they would have made this intention clear, by using substantially the following language:

> "Lessee agrees to pay as a bonus for the execution of this lease the sum of $424,000.00 as evidenced by the Lessee's assumption and agreement absolutely to pay the indebtedness held by The Pacific Mutual Life Insurance Company of California, and secured by a mortgage upon the leased premises, it being understood that since this payment is to be considered a bonus for the execution of the lease, the cancellation of the lease shall in no way relieve the Lessee from the payment of the full amount of such mortgage."

If the agreement had been in the language just quoted, the Lessee would, upon the termination of the lease, have been no more entitled to be relieved from paying unmatured portions of the mortgage than it would have been entitled to recover any portion of a cash bonus which it might have paid upon the inception of the lease. If the parties had agreed that the $424,000.00 should be considered as a bonus for the execution of the lease, then the

holding of the Court of Civil Appeals here would have been correct, and would have been fully supported by the cases upon which it relies. The cases do not actually support that Court's contention in this case.

If the principle for which the United States contends is that there should be allowed each year an average rental expense calculated either over the life of the building or over the full term of the lease, there is no basis of fact upon which to arrive at what the average rental expense would be, if the entire rental expense under Articles II, III and IV of the lease are considered. It would certainly not be fair to prorate only a part of the variable rents and take the amounts as actually paid each year for the other items of rental expense.

The Government is not even consistent in its theory. While asking an average annual amount for the rentals paid in the form of payments on the mortgage, it uses the actual amounts payable each year under Article II, which are themselves variable amounts. It also permits deduction for actual amounts paid each year for taxes and insurance payments, without taking an annual average of these items.

It is highly probable that after 1950 the total annual rental payments of all kinds, paid by Southwestern Hotel Company, will be in excess of the total rental payments of all kinds during the period prior to 1950, yet under the principle contended for by opposing counsel the Southwestern Hotel Company should not now be allowed to deduct its annual current rental expense, because of the apparent assumption that the present expense is more than what it will be hereafter.

The Supreme Court, in numerous cases, has laid

down the rule that tax laws and regulations should be given a practical interpretation and a practical application. We think that when, as in this case, payments on a mortgage debt are to be made over a period of years, as a part of the monthly rentals, in amounts which must be at least $12,000.00 a year during the first three years and at least $20,000.00 a year during the balance of the lease until the mortgage debt is paid, and by the terms of the lease the continued existence of the lease is conditioned upon the prompt payment of these recurring amounts, the sums actually payable each year should be considered as a part of the annual rental deductible for the year in which they accrue.

This is not a case referred to in Article 23(a)—10—Rentals—of Regulations 86, by the following language:

> "If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction on his return an aliquot part of such sum each year based on the number of years the lease has to run."

That language has reference to a bonus. Neither do these payments represent "the cost borne by a Lessee in erecting buidings or making permanent improvements", which may be prorated over the life of the building. Those are the situations covered by the cases relied upon by the Government and by the Circuit Court of Appeals. These recurring payments on the mortgage, paid as a part of the rent, are clearly "rentals or other payments required to be made as a condition to the continued use or possession for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title, or in which he has no equity".

We are confirmed in our view by the opinions in

*Wyoming National Bank v. C. I. R.*, 28 B. T. A. 408, *Denholm and McKay Co. v. C. I. R.*, 39 B. T. A. ....., decided April 14, 1939, *Atlantic Coast Line R. R. Company v. C. I. R.*, 81 F. (2d) 309, Certiorari denied 298 U. S. 656, Rehearing denied 298 U. S. 691, and *Midtown T. Inc. v. C. I. R.*, 40 B. T. A. 116, No. 26, decided June 21, 1939, copy of which opinion is attached as Appendix One.

The last case cited is directly in point. There, the payments on the mortgage did not commence during the first years of the term of the lease, and the Lessee sought, nevertheless, to prorate the entire amount of the mortgage over the life of the lease and to deduct from the first year a proportionate amount of the mortgage thus spread over the full term of the lease, even though no actual payment on the mortgage became due during that year. The Commissioner of Internal Revenue contended that the actual amounts as they became due each year should be deducted as rental expense. He contended that since no payment on the mortgage became due during the first year, no expense could be deducted during that year. In other words, the Commissioner insisted that the amount of the mortgage should not be prorated over the lease, but that each year the actual amount payable in that year should be deducted. His contention there is ours here. The Board of Tax Appeals sustained the Commissioner's contentions.

Both the Commissioner of Internal Revenue and the Board of Tax Appeals have heretofore acquired a wide experience in questions of this character, and we think that the construction placed upon the statute and upon the Regulations of the Treasury by them in the *Midtown* case should receive consideration here.

We also call attention to the evidence in this case

which shows that in connection with the income taxes paid by the Mathias Trust Estate, one of the Lessors in the Hilton lease, the Commissioner ruled that the actual amounts paid by the Southwestern Hotel Company on the Pacific Mutual Life Insurance Company mortgage constituted income to the Lessor in the year when paid. In the letter from the Commissioner it was expressly stated that these payments should be considered as rent. The Commissioner did not then think that the payments on the mortgage should be prorated.

It would be inconsistent to hold that these payments in the actual amounts as paid should be considered as annual *rental income* in assessing income taxes against the Lessor, and should, at the same time, not be considered annual *rental expense* insofar as the Lessee is concerned.

Opposing counsel in the Court of Civil Appeals relied on *Duffy v. Central R. Co. of New Jersey,* 268 U. S 55, 45 Sup. Ct. 429. That case had to do with permanent improvements made by the Lessee. It did not deal with recurring payments made by the Lessee as rent for the continued use and possession of the premises. Clearly, the opinion in that case was sustained by the above quoted language from Treasury Regulations, Article 23(a)—10, which provides that the cost borne by Lessee in erecting buildings or making permanent improvements shall not be deductible as a business expense.

*Galatoire Brothers v. Lines,* 11 F. (2d) 878, 23 F. (2d) 676, is another case from which the United States seeks comfort. There is a clear distinction between that case and ours. There, we have the ordinary case of a bonus paid for a lease. If that lease had simply read, "The present lease is made in consideration of a bonus

of $19,707.63, payable January 1, 1918, and a monthly rental of $250.00 a month", it would have been quite easy to see that it presented the ordinary case of a bonus for a lease. It would be perfectly plain that the $19,707.63 did not constitute "rentals or other payments required to be made as a condition to the continued use or possession for purposes of the trade or business, of property to which the taxpayer has not taken, or is not taking title, or in which he has no equity". Yet the words above quoted are the exact equivalent in meaning of the following language in the lease, "The present lease is made for and in consideration of a monthly rental of Two Hundred and Fifty ($250.00) Dollars, payable monthly, and 50% of the profits of the restaurant conducted in said building during the year 1917, and the obligation on the part of said Lessees to board the Lessor and his family during the year 1917". One-half of the profits for the year 1917 amounted to $16,971.63, and the cost of the meals furnished to the Lessor amounted to $2736.00, which makes the total amount of $19,707.63, referred to in the assumed quotation from the lease. The agreement to pay the lump sum at the end of the first year was clearly a bonus to be paid in addition to the regular monthly rental.

The lease involved in *Baton Coal Company v. Commissioner of Internal Revenue,* 51 F. (2d) 469, was just as clearly one involving bonus payments. There, the lease was made on November 14, 1926. It provided for the payment of $50,000.00 in cash upon the inception of the lease and $51,250.00 in six months, and the payment of a royalty of thirteen cents a ton, with a minimum of $26,000.00 per annum. The two cash payments to be made within the first six months were clearly bonus payments. In fact, the Court said that the Commissioner of Internal Revenue rightly gave as the basis for his rul-

ing, "that those amounts represented a bonus paid in connection with the obtaining of the lease, and should be capitalized and the cost recovered over the life of the lease". The Court also quoted as a basis for its ruling an extract from the Treasury Regulations:

> "Article 110. Rentals—Where leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year based on the number of years the lease has to run."

The situation in our case does not come under the rule with reference to permanent improvements applied in *Duffy v. Central R. Company of New Jersey,* supra, nor under the rule with reference to bonus payments applied in *Galatoire Brothers v. Lines,* supra, and *Baton Coal Company v. Commissioner of Internal Revenue,* supra.

The Circuit Court of Appeals takes as a basis for its ruling Treasury Regulations 86, Article 23(a)—10, which reads:

> "Article 23(a)—10. Rentals—If the leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run."

The Circuit Court of Appeals also relies on its own opinion in the recent case of *Main and McKinney Building Company v. Commissioner of Internal Revenue,* 113 F. (2d) 81. There are characteristics which are common to that case and ours, but we believe there are grounds of distinction which justify a different decision in our case.

In that case, it was clearly shown that the payments in question were a part of the purchase price of a lease. The basic instrument read:

> "Now therefore: Main Realty Company, hereinafter referred to as Grantor, for and in consideration of the sum of $65,547.30, to it in hand paid by Main and McKinney Building Company and the payments and obligations hereinafter mentioned, does hereby transfer, assign and convey unto the said Main and McKinney Building Company . . . the above described lease . . . together with the leasehold estate in the above described property . . . "

The annual payments of $10,000.00 each, payable over a period of years, while also referred to as rent, were expressly designated as a part of the purchase price for the transfer of the lease. Throughout the instrument the transaction was treated as a sale of the leasehold estate, and the parties were designated as "Grantor" and "Grantee". That case came squarely under the Treasury Regulations 86, Article 23(a)—10, which reads:

> "Art. 23(a)—10. Rentals. If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run."

Our case is quite different. Southwestern Hotel Company is the original lessee, not the purchaser of the lease. This regulation, therefore, has no application. Our payments are rentals, required to be made as a condition to the continued use of the Hilton Hotel. We satisfy the very language of Section 23 of Revenue Act of 1934, c. 277, 48 Stat. 680. *Midtown Tower, Inc. v. C. I. R.*, 40 B. T. A. 116.

We have already pointed out that the mere fact that different amounts of rent are specified for different years does not require the fixing of an average rental over the life of the lease. The parties to the lease be-

lieved that property values generally, and especially the rental value of this hotel, would increase as business conditions improved from the 1929 depression. The parties, for that reason, provided for an ascending scale of rents during the first seventeen years, and then, in view of the obsolescence of the hotel building at the expiration of that period, fixed the rent for succeeding years at 6% on the then ground value of the property. We have shown that no attempt is made by the Government to actually determine what the average rent would be over the life of the lease, and, in fact, due to the method of arriving at the rentals payable after 1950, it would be impossible to do so.

There are practical difficulties which arise from adopting the Government's theory. If the lease should, for any reason, be cancelled within the next few years, the Southwestern Hotel Company would have no opportunity to charge out of its income the portions of the principal payments made in excess of the allowed annual deductions of $12,720.00. If the lessee should assign its lease, there is no practical way in which it might receive credit for excess amounts paid annually on the Pacific Mutual Life Insurance Company mortgage. We realize that these difficulties arise when a cash bonus has been paid, but we think these are reasons why the Court should be slow to approve the holding of the Court of Civil Appeals.

The whole theory of the income tax law is based upon the idea that each person should annually pay a tax, based upon the amount of his net income for year. As net income is received, the means are thus provided for the payment of the tax. The adoption of the Government's theory in our case would not comport with this theory,

and in practice would be ruinous to the Southwestern Hotel Company. That Company might earn each year a sufficient net operating profit to pay $12,000.00 a year on the mortgage during the first three years and $20,000.00 a year during succeeding years, but if it earned no more, it would soon face bankruptcy, if required to pay an income tax on all of the $12,000.00 above $4282.82 ($424,000.00 divided by ninety-nine) during the first three years, and all of the $20,000.00 above $4282.82 during the succeeding years, assuming that the $424,000.00 is prorated over the life of the lease.

In conclusion, we reiterate our contention to the effect that the payments on the mortgage did not constitute a bonus, such as was involved in *Galatoire Brothers v. Lines*, supra, in *Main and McKinney Building Company v. Commissioner of Internal Revenue*, supra, and in *Baton Coal Company v. C. I. R.*, supra, nor did they constitute payment for valuable improvements, such as described in the *Duffy* case. They constituted "rentals or other payments required to be made as a condition to the continued use or possession" of the Hilton Hotel property, "to which the taxpayer has not taken or is not taking title, or in which he has no equity". This case does not merely involve the sum of $989.24, and interest, here sued for. After the first three years the principal payments must be at least $20,000.00, and it is quite apparent that in all probability the amount involved in increased income taxes will materially exceed $2000.00 each year for approximately twenty-one years, especially in view of the rapidly rising income tax rates.

This Court has never clearly construed Section 23(a) of the Revenue Act of 1934, which is 26 U. S. C. A., Section 23, in a situation such as is involved here, and should

definitely state the rule applicable to cases of this character. We think it is entirely foreign to the general intent of the income tax law to compel the payment of a tax on gross income without permitting a deduction of the necessary annual expense, and we respectfully ask this Court to grant out petition in this case.

THORNTON HARDIE,
Of El Paso, Texas,

*Attorney for Petitioner.*

## APPENDIX ONE.

### Opinion in Midtown Tower, Inc., v. C. I. R.
40 B. T. A. 116.

This is a proceeding to redetermine a deficiency in income tax of $1,472.98 and a deficiency in excess profits tax of $529.38 for the fiscal year ended February 28, 1934. The issues are, first, whether Petitioner is entitled to include in the cost of a leasehold, for purposes of exhaustion, a consolidated mortgage on the leasehold and the value of certain shares of stock issued in connection with the assignment of the lease to petitioner, and, second, whether the cost of the lease should be exhausted and recovered over the remaining term of the lease or over the life of the consolidated mortgage.

The facts were stipulated and are so found. Petitioner, a New York corporation, became the lessee of premises located at 50 Seventh Avenue, New York City, in the following manner. On November 11, 1930, the Metropolitan Temple, a New York religious corporation, leased the premises to the Ambrose Realty Co. for a term of 21 years, with provisions for three optional renewals of 21 years each, in consideration of certain specified rentals and the performance of certain covenants and conditions contained in the lease.

The lease provided that the lessee would erect an apartment house, maintain it in good repair until the end of the term, and surrender it in good order at that time. The "SIXTH" paragraph of the lease provided, *inter alia*:

> As a further consideration of this lease, the lessee shall, as additional rent, pay and discharge with-

> in thirty (30) days after the same shall become due and payable, all taxes and assessments which may during the term hereby demised or any renewal thereof, be imposed and charged upon the demised premises and all buildings and improvements thereon; and shall pay the interest and installments of principal upon any and all mortgages now or hereafter a lien upon the demised premises not exceeding in the aggregate the principal sum of $900,000 or such lesser amount as shall remain due and unpaid from time to time on the mortgage and mortgages and/or consolidated mortgage referred to in paragraph fifteenth hereof . . . .

In Paragraph "FIFTEENTH", in order to assist the lessee in financing the building operation, the lessor authorized the lessee to contract a loan, secured by a mortgage on the leased premises and the buildings and improvements thereon, not in excess of $767,500, in the execution of which mortgage the lessor was to join. Though the lessor was to assume no personal liability on such loan, it agreed to execute the mortgage jointly with the lessee. The lessee there agreed to consolidate with the Building & Loan mortgage, an existing mortgage already a lien on the premises, in the sum of $132,500, and cause the existing mortgagee to release the lessor from all liability thereon.

This paragraph also provides as follows:

> The principal sum secured by the said consolidated mortgage on the demised premises shall be amortized by the Lessee at the rate of not less than Eighteen Thousand Dollars ($18,000) per annum, payable in two semi-annual installments, said amortization to commence not later than twelve (12) months from the date fixed by the terms of this lease for the completion of said building and to continue at that rate until either the said mortgage shall have

been fully paid or until the date originally fixed for the termination of the term of this lease, or if such lease is renewed until the date on which said renewal term expires, or if said renewal lease is renewed for the second time then until the time when the full principal sum of said consolidated mortgage has been paid, and all renewal, replacement and extension agreements relating to the original and/or consolidated mortgage hereunder authorized shall so provide.

Paragraph "FORTY-FIRST" of the lease provided that all payments required to be made by the lessee under the leasing either to the lessor or otherwise should be regarded as additional rent.

On November 12, 1930, the Ambrose Realty Corporation assigned the lease to the Fifty Seventh Avenue Corporation, the assignee covenanting with both the assignor and Metropolitan Temple to perform all of the obligations of the lessee contained in the lease. Notwithstanding the assignment, it was provided that the Ambrose Realty Corporation would continue to remain liable under the lease. Thereafter, Fifty Seventh Avenue, joined by the Metropolitan Temple, executed the consolidated mortgage of $900,000, due March 13, 1937, entered upon the property and erected the required building, in accordance with the terms of the lease.

Because of arrears in taxes, interest and mortgage amortization, the lease was modified on February 27, 1933. The changes made, so far as here material, were as follows: The requirement to amortize the principal of the mortgage prior to January 1, 1937, was omitted, except in so far as the holder of the mortgage might require it. On January 1, 1937, amortization payments by the lessee were to be resumed at a rate not less than $9,000 semiannually and continued until the termination

of the original lease term or until the expiration of the first renewal term, and if there should be a second renewal, until the full principal sum of the mortgage should have been paid. The provision that all payments required to be made by the lessee under the lease to persons other than the lessor should be regarded as rent, was reiterated. Finally, the modification agreement provided that on condition the lessee should remain liable on all the terms, covenants and conditions of the lease as modified, the lessor consented to the assignment of the lease, as modified, to petitioner.

On the same day, the Fifty Seventh Avenue Corporation and Metropolitan Temple entered into an agreement with the New York Title & Mortgage Co., the holder of the mortgage bond, which deferred payment of all installments of principal due or to become due until March 13, 1937. The modified lease was thereupon assigned by the Fifty Seventh Avenue Corporation to petitioner, subject to the mortgage on the fee on which there was then unpaid the sum of $900,000.

The final transaction of February 27, 1933, was the execution of an agreement between the Metropolitan Temple and petitioner which recited that in consideration of the consent by the Metropolitan Temple to the assignment of the lease to petitioner, petitioner assumed and agreed to be bound by all of the terms, covenants, provisions and conditions to be performed on the part of the lessee, as modified by the agreement between the Fifty Seventh Avenue Corporation and the Metropolitan Temple. In addition, this agreement stated that the Metropolitan Temple consented to the assignment, provided the Fifty Seventh Avenue Corporation continued to be bound under the lease.

In connection with the assignment of the lease, Peti-

tioner expended $43,167.61, representing payments of arrears of interest, taxes, etc., due at the time of the execution of the assignment.

On February 27, 1933, the Fifty Seventh Avenue Corporation wrote the following letter to petitioner:

> "Referring to the sale of the lease and leasehold estate of premises 48-60 Seventh Avenue, New York City, by the undersigned to you, consummated this day as of March 1, 1933, kindly draw or endorse the checks for the consideration to the extent of Forty Thousand Thirty-two and 15/100 Dollars ($40,032.-15) to the order of New York Title and Mortgage Company, check for One Thousand Dollars ($1,000) in accordance with approval of payment thereon, and kindly issue the two and one-half (2½) shares of stock of your corporation in the name of Edward Levy.

Simutaneously with these instructions, petitioner's chief stockholder entered into an agreement with Edward Levy whereby the stockholder received an option to purchase this stock. The stockholder actually purchased the stock from Levy on December 18, 1933, for the sum of $5,000.

In its return, on the accrual basis, petitioner deducted $18,863.35, representing a 2 percent amortization of the cost of the leasehold apparently spread over the expected period of the mortgage. In this cost, petitioner included the $900,000 principal of the mortgage, and the $43,167.61 expended in connection with the assignment. In its petition it contends that $5,000, representing the value of the stock issued to Edward Levy in connection with the assignment, should also be included.

In its return for the fiscal year ended February 28, 1934, petitioner claimed a deduction of $18,863.35 for

amortization of its leasehold costs. This sum constituted two percent of $943,167.61, which is the aggregate of $900,000, the principal amount of the consolidated mortgage, and $43,167.61, which it paid on account of past due taxes and other expenses in connection with the assignment of the lease to it. The respondent disallowed the deduction except as to the item of $43,167.61, which he determined was properly amortizable over the term of the original lease. This determination, as to the proper period over which this conceded item of cost of the lease is to be amortized, is correct. *Bonwit Teller & Co. v. Commissioner*, 53 Fed. (2d) 381; *1620 Broadway Corporation*, 36 B. T. A. 149.

The issue remaining is whether the cost of this leasehold to petitioner includes also any part of the consolidated mortgage and $5,000, as the value of two and one-half shares of petitioner's stock issued to a nominee of the assignor in connection with the assignment of the lease to petitioner. The position of petitioner is that (1) it assumed the entire mortgage obligation of $900,000 at the time it acquired the lease and is therefore entitled to include this entire item in its cost; and (2) even if the fact of that assumption be ignored, the mortgage existing on the leasehold represents a cost thereof to petitioner.

It would seem clear that only such part of this mortgage as may be considered invested by the petitioner in the leasehold can be considered as includable in its cost for amortization purposes. *Duffy v. Central Railroad of New Jersey*, 268 U. S. 55. It may well be that the personal assumption of the mortgage by petitioner, even though payments thereon were postponed until a year after the tax year, would suffice for that purpose. See *Brons Hotels, Inc.*, 34 B. T. A., 376; *John D. Fackler*, 39

B. T. A. 395. But, without petitioner's assumption of that personal liability, at least, payments, neither due nor made during the tax year, do not constitute an investment in or cost of the lease to petitioner. That is the converse of our decisions holding that one who owns real estate subject to a mortgage, the payment of which the owner did not personally assume, receives nothing upon a foreclosure sale of such real estate. *Commonwealth, Inc.,* 36 B. T. A. 850; *Sol Greisler,* 37 B. T. A. 542; affd., *sub nom Commissioner v. Frichofer,* 102 Fed. (2d) 787. This disposes of petitioner's second contention on this issue.

Assuming, but not deciding that such part of the consolidated mortgage here, the payment of which was personally assumed by the petitioner, was includable in its amortizable cost of the leasehold—was any part of this mortgage so assumed?

Petitioner acquired the lease from the lessor, through its assignor, the Fifty Seventh Avenue Corporation. Thus, as to the provisions of the lease, petitioner is in exactly the position of the prior lessee. *Cogar v. Commissioner,* 44 Fed. (2d) 554. But petitioner was neither a party to nor has assumed the payment of the mortgage as such. It is personally liable only so far as the lease provides. Its only obligation in that connection under the lease was to "pay the interest and installments of principal upon any and all mortgages now or hereafter a lien upon the demised premises not exceeding in the aggregate the principal sum of $900,000, or such lesser amount as shall remain due and unpaid from time to time on the mortgage and mortgages and/or consolidated mortgage referred to in paragraph fifteenth hereof."

Paragraph "FIFTEENTH" provided that the con-

solidated mortgage "shall be amortized by the Lessee at the rate of not less than Eighteen Thousand Dollars ($18,000.00) per annum payable in two semi-annual installments". And the modification of the lease, effected before the assignment to petitioner, postponed any payments on the mortgage until March 13, 1937. Under such circumstances, we think that petitioner's only personal liability was that of a lessee and not as a borrower. See *379 Madison Ave., Inc.*, 23 B. T. A. 29; reversed on other grounds, 60 Fed. (2d) 68. And as such, during the taxable year, it had no personal liability to make any payment on account of the mortgage. It follows, we think, that no part of the consolidated mortgage on the leasehold forms a part of the cost of the leasehold to petitioner. Respondent was right in denying petitioner any amortization deduction on account of it, for the taxable year.

Petitioner raises, for the first time in his petition, the question as to whether or not the value of two and one-half shares of its stock, issued to a nominee of the assignor of the lease, should be included in petitioner's cost of the leasehold. Aside from any other frailties in this position, the agreement under which this stock was issued is not in evidence nor is anything disclosed as to why it was issued. We hold that this item is not a part of petitioner's cost of the leasehold for amortization purposes.

*Decision will be entered for the respondent.*

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296837—41

# In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 752

SOUTHWESTERN HOTEL COMPANY, PETITIONER

*v.*

UNITED STATES OF AMERICA

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT*

## BRIEF FOR THE UNITED STATES IN OPPOSITION

### OPINION BELOW

The District Court did not file a written opinion. Its special findings of fact and conclusions of law are printed in the record at pages 22 to 28, inclusive. The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 59–62) is reported at 115 F. (2d) 686.

### JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 19, 1940. (R. 63.) The petition for a writ of certiorari was filed on Febru-

ary 7, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

### QUESTION PRESENTED

Petitioner, a lessee of certain improved real estate under a 99 year lease, agreed not only to pay a specified rental but also to make payments in discharge of the lessor's mortgage. The question presented is whether the amount paid by petitioner in 1935 upon the mortgage is deductible in full from its taxable income for that year or whether it should be spread over a longer period.

### STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the tax-

payer has not taken or is not taking title or in which he has no equity.

* * * * *

[U. S. C., Title 26, Sec. 23.]

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 23 (a)-10. *Rentals.*—If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation. If the remainder of the term of lease is greater than the probable life of the buildings erected, or of the improvements made, this deduction shall

take the form of an allowance for depreciation. (See article 22 (a)–13.)

STATEMENT

This suit was brought against the United States in the District Court for the Western District of Texas to recover $989.24 alleged to have been illegally collected from the petitioner as federal income and excess profits taxes for the fiscal year ended August 31, 1935. (R. 1–17.) The District Court made special findings of fact and conclusions of law (R. 22–28), and entered judgment for the United States (R. 37–38). The Circuit Court of Appeals affirmed. (R. 59–63.)

Petitioner is a Texas corporation. (R. 22.) On or about September 1, 1933, one Albert Mathias, joined by his wife, as lessor, entered into a lease contract with petitioner, as lessee, by the terms of which the lessor leased to petitioner certain property in the City of El Paso, Texas, generally known as the Hilton Hotel property. The lease, for a period of 99 years beginning September 1, 1933, and ending August 31, 2032, contained provisions for graduated monthly rentals, and provided that petitioner should pay certain other items (not material here) as additional rentals. The lease also provided that the lessee was to make payment upon a mortgage note which the lessor had theretofore executed (R. 23–24):

ARTICLE III.

ADDITIONAL MONEY RENTALS

(1) As a further consideration for this lease, the Lessee covenants and agrees to pay all sums due and to become due on a certain note, originally in the principal sum of $450,000.00, which is described in a certain Deed of Trust, executed by Albert Mathias and wife and El Paso Hilton Hotel Company on the 28th day of February, 1930 * * *. The Lessee shall have the right to arrange for renewals and extensions of said indebtedness from time to time, and may also arrange for a complete refinancing of same. In such cases, Lessor agrees to execute such Deeds of Trust, mortgages and extension agreements covering both real and personal property as may be required; provided (a) that the terms and provisions of such Deed of Trust, mortgage or extension agreement shall be substantially the same terms and provisions as are now contained in the Deed of Trust and Chattel Mortgage covering said property; and (b) that the amount of the indebtedness then secured by a lien against said property is not increased. In this connection, it is understood that Lessee shall be required to reduce the principal of the indebtedness secured by lien against said property not less than $12,000.00 a year during the first three years, and not less than $20,000.00 a year

> during succeeding years, such indebtedness not to bear interest in excess of the interest rate now provided for * * *.

The unpaid balance on the note held by the Pacific Mutual Life Insurance Company of California on September 1, 1933, was $424,000 and was payable over a period of years, which period was shorter than the estimated life of the building. The estimated life of the building was 33⅓ years. (R. 24.)

There became due and payable on the mortgage indebtedness during the fiscal year ended August 31, 1935, the sum of $18,000, which was paid by petitioner during that year. (R. 24.)

The Commissioner of Internal Revenue ruled that while $18,000 actually became due during the 12 months' period, and was paid, such payment should not be considered as deductible in full for that year, but should be taken together with other payments on the mortgage and spread over the undisputed life of the building, namely 33⅓ years.[1] Pursuant to this ruling, the Commissioner allowed as a deduction for the year 1935 only $12,720, and disallowed as a deduction the remaining $5,280. As a result, petitioner's income and excess profits taxes were increased by $989.24, which, together

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[1] Petitioner originally sought a deduction in the amount of $27,500, but $9,500 thereof was disallowed (R. 24–25), and is not now in dispute. The only controversy here relates to the question whether the remaining $18,000 is deductible in full for the fiscal year 1935.

with interest in the amount of $196.13, was paid on or about March 9, 1939. (R. 25–26.) This suit for refund followed.

ARGUMENT

This case presents neither a conflict of decisions nor a question of general importance. The decision below, based upon the particular facts of this case, is correct.

The applicable statute provides for the deduction from gross income of all ordinary and necessary expenses paid or incurred in the taxable year, including "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business," of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

The courts and the Board of Tax Appeals have consistently construed this provision, as did the court below in this case, as limiting the deduction to amounts paid as rent for the use of the property for the taxable year, and have refused to allow any deduction of amounts paid during the taxable year for the use of the property in future years. The principle was established by this Court in *Duffy* v. *Central R. R.*, 268 U. S. 55. See also *Galatoire Bros.* v. *Lines*, 23 F. (2d) 676 (C. C. A. 5th); *Baton Coal Co.* v. *Commissioner*, 51 F. (2d) 469 (C. C. A. 3d). The issue was recently presented in *Main & McKinney Bldg. Co.* v. *Commissioner*, 113 F. (2d) 81 (C. C. A. 5th),

and this Court denied certiorari, No. 403, present Term. Assumption of a lessor's liability with provision for payment over a period of years is in substance the same as a lump sum payment upon execution of a lease, and is in essence the payment of an amount to acquire the lease. Compare *Alameda Park Co.* v. *Commissioner,* 10 B. T. A. 1115, reversed on another ground, 37 F. (2d) 805 (App. D. C.); *King Amusement Co.* v. *Commissioner,* 44 F. (2d) 709 (C. C. A. 6th), certiorari denied, 282 U. S. 900; *Davison* v. *Commissioner,* 60 F. (2d) 50 (C. C. A. 2d); *Fackler* v. *Commissioner,* 39 B. T. A. 395. Such payments should be amortized over the life of the lease. *Coronado Realty Co.* v. *Commissioner,* 24 B. T. A. 1022; *Minneapolis Security Building Corp.* v. *Commissioner,* 38 B. T. A. 1220.

Whether "Additional Money Rentals" (R. 23), representing payments which the petitioner agreed to make upon the outstanding mortgage note in question, constituted payments for the current use of the property or constituted additional consideration for the granting of the lease depends upon the agreement between the parties. Cf. *Main & McKinney Bldg. Co.* v. *Commissioner, supra.* The court below properly construed their agreement requiring that such payments be made "as a further consideration for the lease" (R. 61) and correctly affirmed the decision of the District Court.

## CONCLUSION

There is no conflict of decisions. The decision below is correct. The petition should be denied.

Respectfully submitted.

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